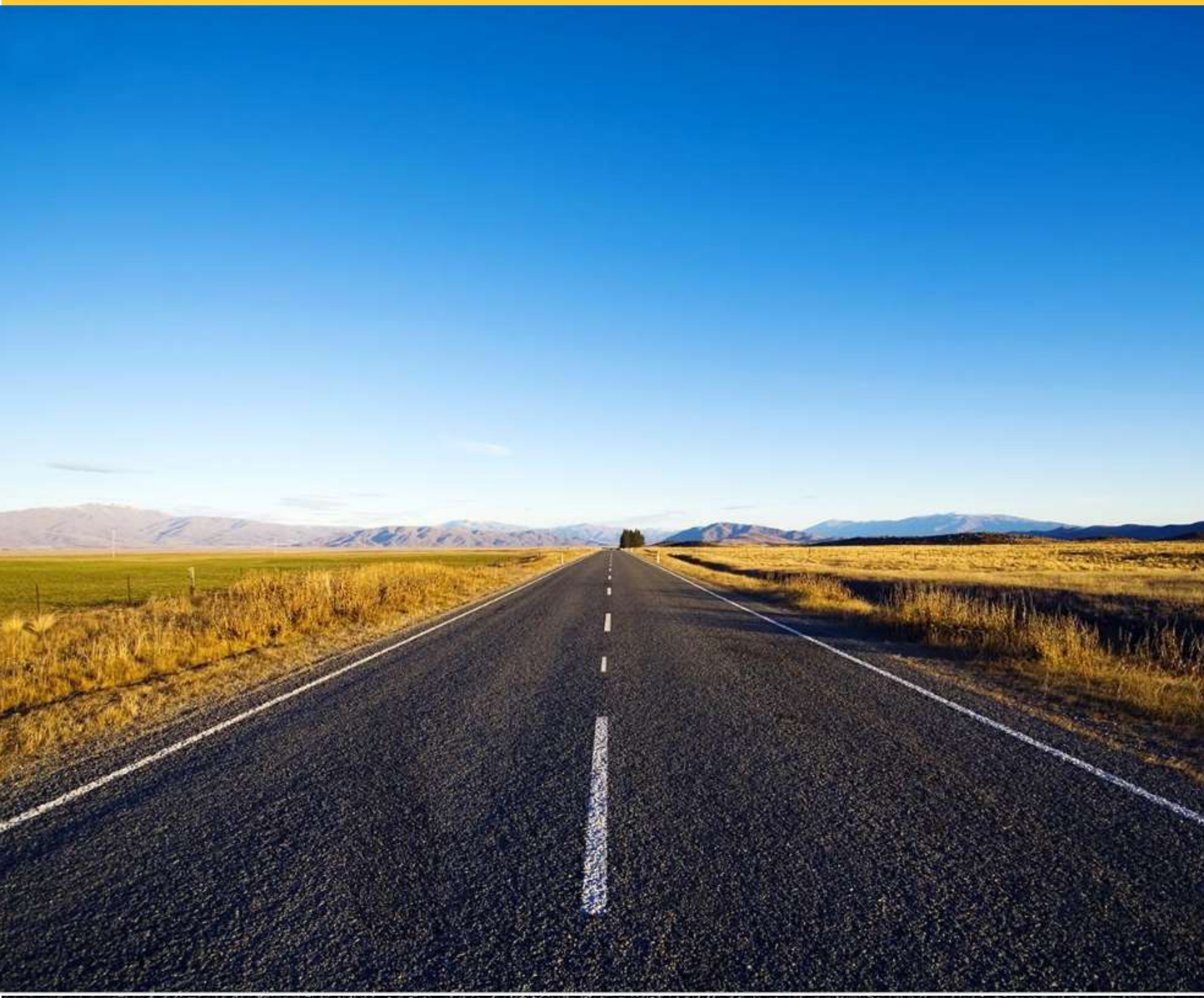
STANFORD BROWN

Financial Advisers

Monthly Investment Markets Report

3 September 2020



Investment markets in August

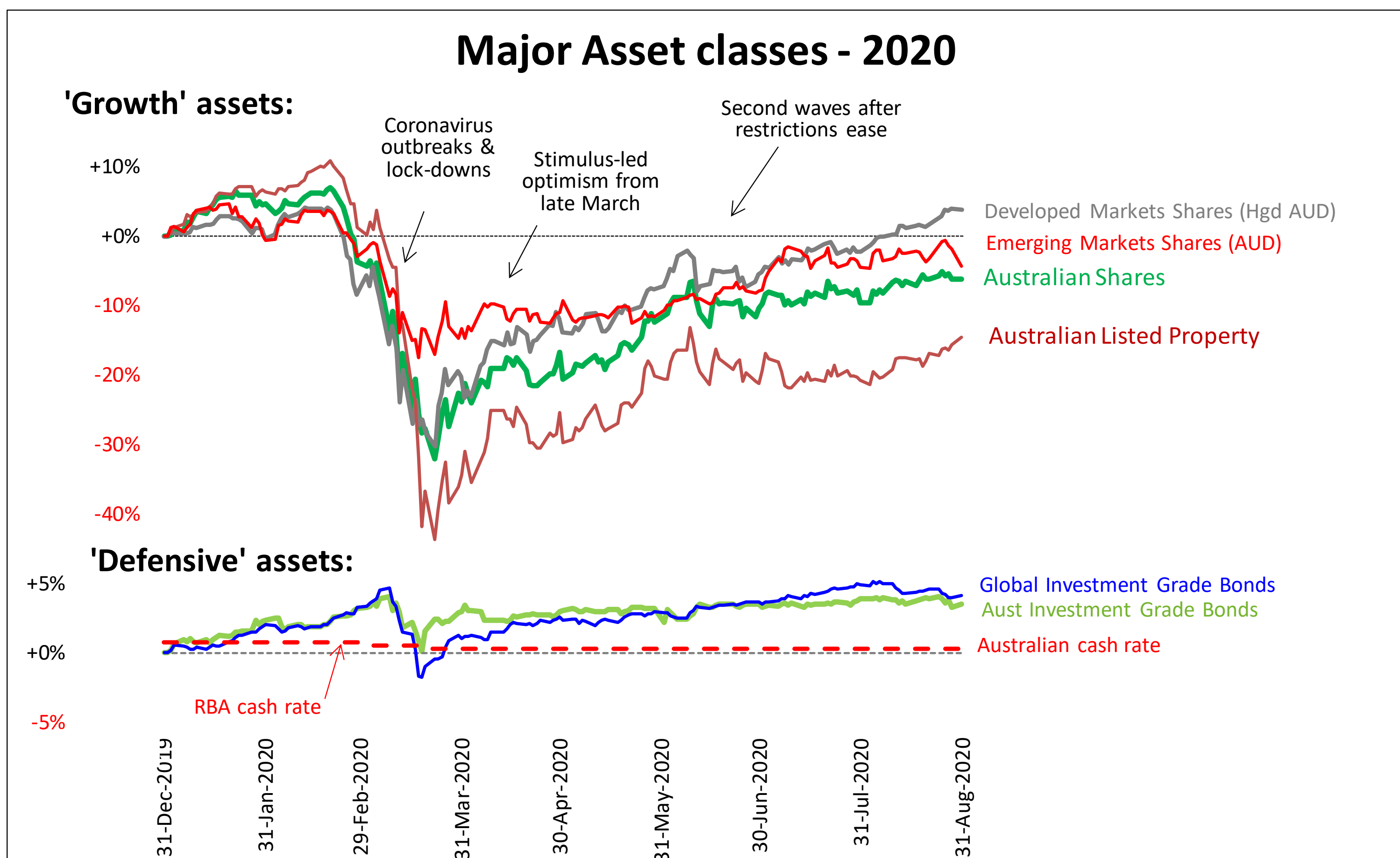
August was another month in which the negative impacts of second waves of virus outbreaks and lockdowns, depression-era economic contractions, and a sea of red ink in corporate profits and dividend announcements, were more than offset by optimism that corporate profitability will soon be restored, propped up by governments' fiscal and monetary stimulus and support measures.

On the coronavirus front – global infections now total 25.6 million (up 2,600% since March). New infections are running at an average of 25,000 new infections per day, which is 10 times the daily average in March. Deaths now total 850,000 (up 1,800% since March). Deaths are running at about 5,500 deaths per day (also 10 times the daily average in March). The US still leads but Brazil and India are rising rapidly. We use March as the base here as that was when the share rebound started.

In Australia, the crisis is also far from over. Infections now total 25,900 (up from 4,763 at the end of March). In August, new infections ran at an average of 285 per day, which is still higher than the average rate of 150 per day in March. Deaths now total 652 (up from just 20 at the end of March). In August, deaths ran at an average of 14 per day, compared to less than 1 per day in March. The Melbourne second wave has now slowed with the lockdowns, but new outbreaks can appear at any time and place as lockdowns and restrictions are eased.

On the stimulus front, governments in the US, Australia and other major markets extended their stimulus programs, and their central banks also maintained their support in the form of near-zero interest rates, bond buying, and cheap loans to support lending. On the economic front, Australia and several other countries posted depression-era contractions. There were no major negative surprises on either front. We have written extensively in recent editions that economic recessions have generally been positive for shares in the past. Share prices fall before recessions and then rebound from the middle of recessions while economies are still contracting and companies are posting losses and/or collapsing. This is not to suggest that history repeats, but the current experience is consistent with most past recessions and economic contractions.

The chart below shows returns from the main asset classes so far in 2020. The upper section shows that 'risk' assets are on the way to recovering from the February-March coronavirus shutdown sell-off while the virus crisis continues to escalate and economic numbers confirm the deepest contractions since the 1930s.



The Australian share market posted another strong month during the main reporting season, which produced more positive than negative surprises. Two-thirds of stocks rose during the month. Best were tech stars Wisetech (+36%) and Afterpay (+33%). Several cyclical stocks advanced on hopes of the early lifting of restrictions - including Flight Centre (+25%) and Qantas (+22%). Stockland (+24%) led the property trusts up on signs of a truce between shopping centre landlords and tenants. Oil/gas stocks were also stronger generally as the oil price recovery continued for a fourth straight month. Worst for the month was Whitehaven (coal, -33%) with a worse than expected report and lower coal prices. Treasury Wines (-14%) and a2Milk (-12%) were sold off on fears of retribution from China, and Telstra was also down (-14%, self-inflicted).

The local market index remains 8% below the start of the year. It is not just the banks weighing the market down. Only 34% of stocks are ahead so far this year. Later in this report, we look in more detail at the August profit reporting season and the impacts on share prices.

Commodities prices continued to rise in the general global recovery optimism and strong levels of steel-making and construction activity in China. Iron ore was up another 12% in August as Brazil struggled to re-open its mines and ports, but gold was flat. Both are up 30% for the year. Most of the other industrial commodities were also a little higher again in August, finally putting them ahead for the year, except for lithium and coal, which are well below still.

On the currency front, the Aussie dollar continued to rise along with shares in August, especially against a weaker US dollar and Chinese RMB. The slide in the US dollar since March has caused alarm in some quarters but it is entirely consistent with the usual pattern in most conditions, where the USD generally falls during global share rallies and rises in sell-offs. Despite the 5-month slide in the USD since the March crisis, it is still higher than it was at the start of this year, and higher than it has been for most of the past 30 years. The US Fed stepped up its efforts to bring down the US dollar to help US exporters, which we cover below.

Global share markets had another strong month in August, up 6% overall. The best returns were from the big US tech stocks, along with cyclical stocks benefiting from rebound optimism, not only in the US but across almost all other major markets. The US tech giants led the charge – Microsoft +10%, Facebook +15%, Alphabet (Google) +10%, Adobe +15%, Nvidia +26%, and even Uber was up 11%.

Apple was the star, gaining +21% in August on its 4:1 share split. This phenomenon of share prices jumping on news of a split is completely illogical of course. Investors raced in to buy up Apple shares on the news because $125 per Apple share suddenly appeared better value than $500 before the split. It should not make a difference of course because all the company did was split each existing share into four new ones, but whoever said investors were logical?

The cyclical rebound theme also drove discretionary spending stocks were higher, including Amazon +9%, Alibaba +14%, Toyota +13%, Nike + 14%. Likewise for industrials, including Boeing +8%, Airbus (France) + 11%, Honeywell +11%, and UPS +14%. Consumer staples were generally positive, but up by less: Walmart +7%, Costco +7%, Proctor & Gamble +5%. Other sectors were also up a little – financials, healthcare, and oil/gas with higher oil prices. The only negative global sector for the month was utilities, thanks to the rise in bond yields.

The good August result was enough to put global shares ahead for the 2020 year to date. Not bad for the deepest economic contraction since the 1930s Great Depression. With global corporate profits down around 21% this year (from $3.0 trillion to $2.37 trillion annualised), the fact that share prices have recovered means pricing relative to reported profits have expanded into even more expensive territory than they were at the start of the year. A lot is riding on the assumptions of continued government support in the form of deficit spending, and compliant central banks to keep interest rates low, keep buying up bonds, and providing cheap loans to banks and companies.

On a country-by-country basis, the US led the way in August, but Japanese and European shares were also positive. For the year to date, the US, China, South Korea and Taiwan are the only major markets above where they were at the start of the year (all are driven by tech stocks), but most of the others are not far behind. Australia is bringing up the rear, despite the fact that our rates of virus infections and deaths (per capita) are among the lowest in the world, and our economic recession is shallower than most. We look at Australian company results and implications in more detail later in this report.

Defensive assets

The lower section of the above chart shows that even the safest of 'investment grade' bonds fell dramatically during the February-March sell-off, whereas ordinarily they would be expected to gain in value as investors rushed to the safety of government bonds. However, investors dumped even the safest of government bonds as they feared governments everywhere would have trouble financing their huge deficit spending programs. On cue, central banks came to the rescue and promised to keep interest rates low for their governments and also to buy up whatever bonds their governments needed to finance the deficits. Since then, bond markets have recovered smoothly, safe in the knowledge than central banks would step in to fix whatever problems the formerly free-market encountered.

Bond markets were lower in August as bond yields started to rise. This time it was not because investors feared governments would have trouble financing their deficits, but because of the emergence of inflationary fears as the recovery gathered pace.

The US Federal Reserve made a major change in policy direction on 27 August when it announced it will tolerate inflation running above its 2% target for extended periods in order to achieve an average inflation target, rather than a ceiling of 2%. This probably means it will keep interest rates lower for longer, and it will tolerate higher inflation for longer before finally lifting rates. This prompted investors everywhere to switch more money from bonds into shares, pushing bond markets down, share markets up, and the US dollar down further.

In Australia, the RBA is under renewed pressure to lower interest rates to bring down the Aussie dollar in the Fed's renewed currency war. The RBA kept its official target cash rate at 0.25% again but has been running the actual cash rate at just 0.10% to 0.15% since the March crisis. It also returned to 1950s-style interest rate pegging to keep bond yields low so the government can borrow the additional $200-300b of debt it needs to fund the huge deficit spending programs.

Later in this report we turn to the question of whether this growing pile of government debt is prudent or affordable.

Portfolio Returns

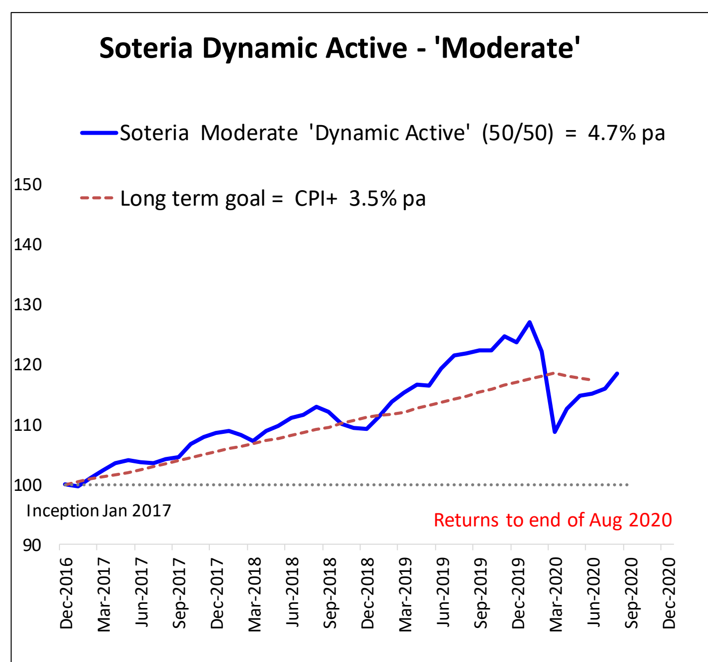
Portfolios had a good month in August, with share markets posting good gains. Falls in bond markets caused by the inflation scare were partially cushioned by the fact that we are under-weight fixed-rate bonds.

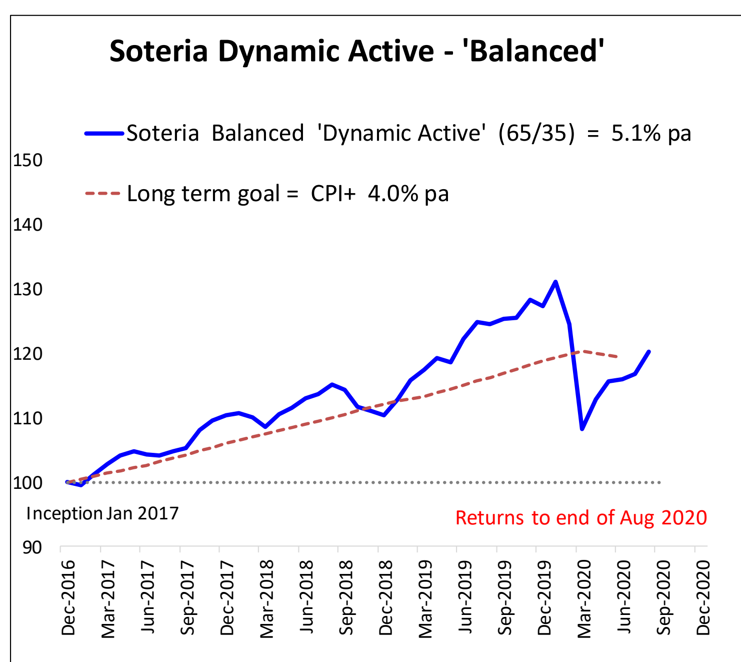
This table summarises returns from our ten main model portfolios for the month of August.

	SOTERIA 'Dynamic Active' models					SOTERIA 'Dynamic Index' models				
Model	'Conservative'	'Moderate'	'Balanced'	' Growth'	'High Growth'	'Conservative'	'Moderate'	'Balanced'	'Growth'	'High Growth'
'Neutral' growth defensive mix	30/70	50/50	65/35	80/20	95/5	30/70	50/50	65/35	80/20	95/5
Current growth defensive mix	31/69	51/49	66/34	81/19	94/6	31/69	51/49	66/34	81/19	94/6
Long term CPI+ goal	CPI +3%	CPI +3.5%	CPI +4%	CPI +4.5%	CPI +5%	CPI +3%	CPI +3.5%	CPI +4%	CPI +4.5%	CPI +5%
August month returns	1.26%	2.18%	2.87%	3.58%	4.22%	1.24%	2.25%	3.05%	3.77%	4.54%

The next two charts show total returns (ie including re-invested income, and after fees) from our most popular portfolios 'Moderate' and 'Balanced' – since their inception at the start of 2017. (We offer a full range from 'Conservative' through to 'High Growth', and each of these have two types – *'Dynamic Active'* – which include a mix of passive index funds and actively managed funds; and '*Dynamic Index*' – which use index funds only. Most of the investors' funds are in 'Moderate' or 'Balanced' *Dynamic Active* portfolios).

The dark blue line in the charts show the cumulative portfolio returns over time. The red dotted line shows each portfolio's long term goal for returns above the rate of inflation. Note that the inflation-based line has dipped in the June quarter 2020 with negative price inflation in the June quarter. These 'inflation-plus' targets are the main long term return objectives for each portfolio, but the actual portfolio returns will oscillate around these total return targets from time to time – for example in late 2018 and during this year's coronavirus crisis.





At the end of July we increased allocations to shares and reduced 'defensive' assets, and this has added value as share markets did well in August. In Australian shares, above-market returns were posted by Bennelong, Allan Gray, MVW and Ironbark Karara, due to their focus on small and mid-sized companies. Listed property fund MVA also had a very strong

month. In global shares, the currency-hedged funds beat the un-hedged funds as the Australian dollar rose. At the end of July we also reduced our exposure to infrastructure (removing AMP Infrastructure fund) as infrastructure faces headwinds of lower post-covid pricing and also rising bond yields in the medium term. This decision added value as infrastructure lagged in August.

On the defensive side, our holdings of corporate bonds (PLUS in Australia, and VCF globally), and also floating-rate funds (Perpetual, FLOT) added value as government bonds suffered negative returns as bond yields rose in Australia and around the world.

Our portfolios are slightly above 'neutral' in their mix of 'growth' and 'defensive' assets. On the 'growth' side we are slightly biased toward global over Australian shares and under-weight property. On the defensive side, we are biased toward Australia, and we also hold more high grade floating rate securities and less fixed rate than usual, as we are wary of the low bond yields and potential for rising inflationary fears in Australia and the US.

Monthly returns for all portfolios since inception are at the end of this report

Australian company reporting season – a sea of red ink, but some good news

In this edition we spend more time than usual on the local company reporting season, for two reasons. First, August is the main reporting season each year in Australia; and second, it is the first chance to take a comprehensive look at the how the virus-related shutdowns have affected aggregate corporate revenues, profits and dividends.

Although this August reporting season for Australian listed companies was the worst since 1931, it provided very few negative surprises and a significant number of positive surprises. Despite the sea of red ink from contractions of 40% or more in aggregate profits and dividends, there were no major negative developments and no flood of corporate bankruptcies. The absence of major negative news, and some surprisingly good outcomes, sent the overall share market higher in August.

Here is a quick snapshot of the results (revenues, profits and dividends) from the largest 160 companies that reported:

- Revenues were virtually flat at around $610b in aggregate – almost the same as last year. A majority of companies (55%) actually posted *higher* revenues, while the other 45% reported lower revenues. These are surprisingly good outcomes in light of the fact that we are in the midst of the sharpest and deepest contraction in economic activity and employment since the 1930s 'great depression' – in Australia and around the world.
- Profits were down by -45% from $71b to $38b in aggregate. This was not materially different from what was feared earlier in the year, and it was those fears that triggered the sharp share sell-off in February-March.
- Dividends were also down by about 40%. Most of the reductions were due to cuts from the big banks, which ordinarily account for around 35-40% of total dividends across the market. These were also flagged months ago.

Several companies posted revenues, profits and shareholder dividends (and also CEO bonuses) that had been boosted by the government's welfare handouts, including 'JobKeeper' (Thank you future generations of taxpayers!). This is very similar to the scandal in the 2008-9 GFC where tax-payer bail-out money ended up funding bankers' bonuses and shareholders' dividends – sparking popular outrage that started movements like 'Occupy Wall Street', 'Main Street, not Wall Street' and 'The Other 99%'. This time around the transfer of wealth from future generations of (now young) taxpayers into the pockets of old, almost-all-white and almost-all-male CEOs, and old, tax-advantaged retiree shareholders – will probably be longer lasting, and will only further inflame the intergenerational divide.

A note on the company results summarised here - The numbers in this report are aggregates from the profit reports for the largest 160 companies in the August reporting season in respect of the period ending June 2020. Most companies in Australia have June financial years, and for these companies it was their full-year result relative to the prior financial year to June 2019. Of the small minority of companies that don't have June years, most have December years, and their June reports were for the half-year to June. There are also a small number of companies that have years ending in other months – notably ANZ, NAB and Westpac have September years, and we include their third-quarter results to June. Some other companies have non-standard financial years (eg Macquarie Bank has a March year). These companies do not provide detailed reports to June and so are not included in the aggregates.

As a result, the aggregated numbers reported to June are somewhat lower than a full 12 months' results for the market. This is sufficient for our current purposes here – to compare the most recent results against the same period last year.

Looking in more detail at revenues, profits and dividends in turn:

REVENUES

Aggregate 'top-line' revenues were virtually flat at $610b, which is less than 1% lower than last year, with 55% of companies posting higher revenues than last year. This was mainly due to revenue surges in the retailers (benefiting directly and indirectly from welfare handouts), and from the iron ore miners.

The biggest revenue gains were from the following companies:

- The big retailers - Woolworths (+$3.7b), Coles (+$2.4b), Wesfarmers (+$2.9b), JB Hi-Fi (+$824m) – mainly due to consumer stockpiling in the lockdowns, and increases in spending to set up home offices, supplemented by the government welfare handouts.
- Resources - Fortescue (+$2.9b, due to surging iron ore prices and volumes, thanks to supply problems in Brazil and strong steel production in China), Worley (oil/gas engineering, +$6.1b, largely due to the addition of its ECR acquisition last year)
- Insurers - IAG (+$900m), QBE (+$750m)

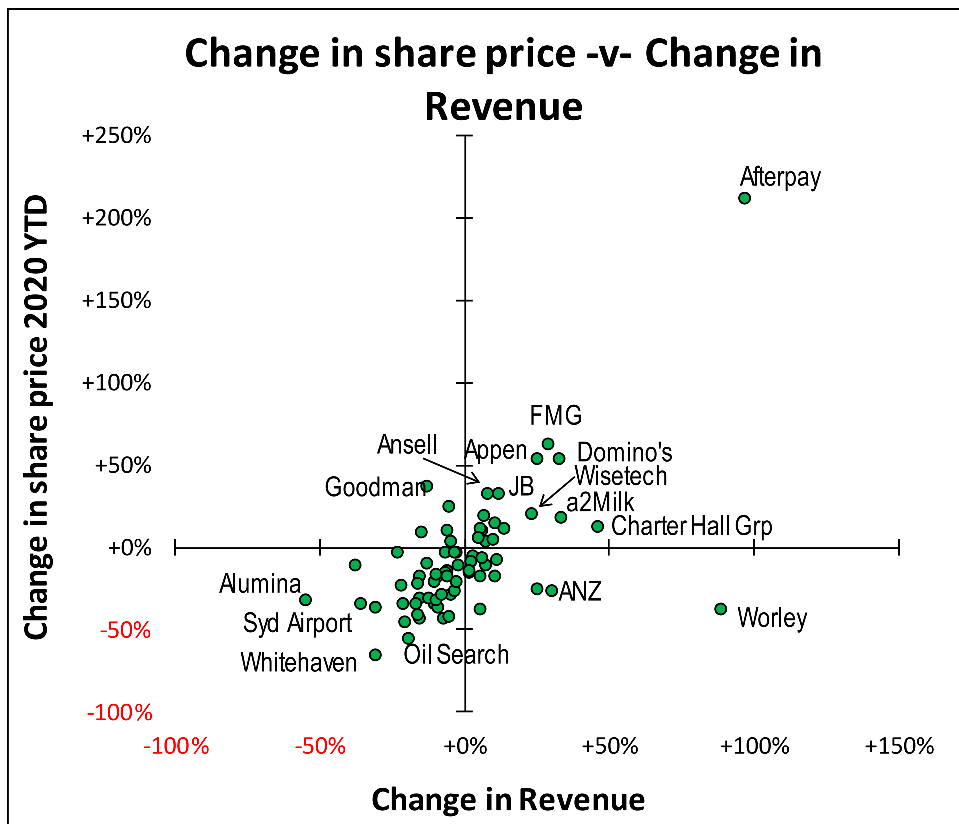
- Healthcare - CSL (+$612m), Ramsay Healthcare (+$840m)

The big reductions in revenues came mainly from:

- Qantas (-$3.7b), Telstra (-$1.6b), NewsCorp (-$1b), AGL (-$1.1b)
- Miners – BHP (-$1.3b), RIO (-$1.4b), South32 (-$1.2b), BlueScope steel (-$1.3b) – with the general slide in prices of most industrial commodities apart from iron ore and gold
- Energy – Origin (-$1.6b), Ampol (formerly Caltex, -$2.2b), Viva (-$1.2b) – due to the collapse in oil prices
- Challenger (-$1.2b), LendLease (-$3.2b), Flight Centre (-$1.2b)

Overall, the fact that market-wide top-line revenues remained virtually flat was a better result than expected. However, the lockdowns from March only impacted part of the year's reported results, and continued lockdowns will further impact the current year's results. The virus crisis is still very active in Australia and most of the world, with no vaccine in sight.

The chart below plots companies by the change in their share price so far in 2020 (vertical axis), versus the change in reported revenue in their reports to June (horizontal axis):



Most companies fall into one of two main segments: The upper-right segment, with higher revenues and higher share prices. These are the winners – led by Afterpay, FMG, Appen, Domino's, JB, Ansell, Wisetech, a2Milk and Charter Hall Group. The other crowded segment is the lower-right, with lower revenues and lower share prices. As expected, worst affected were oil/gas stocks and those most directly affected by the lockdowns (Sydney Airport, Qantas, etc).

PROFITS

While top-line revenues were flat for the year, aggregate bottom-line profits were down $32b or 45% on the same period last year. One-third of companies posted higher profits, one third posted lower profits, and the remaining third posted losses.

- The main contributors to higher profits were: - Fortescue (+$1.5b), CBA (+$1b), ANZ (+$550m), Westpac (+$210m), AMP ($2.5b, but that was merely a rebound from last year's losses), Suncorp (+$740m), ResMed +$220m).
- The main reductions in profits were from: – Woodside (-$4.4b), Wesfarmers (-$3.8b), Qantas (-$2.8b), Vicinity (-$2.1b), Tabcorp (-$1.2b), Woolworths (-$1.5b), Boral (-$1.4b), NewsCorp (-$1.8b), QBE (-$1.2b). Some of these included large write-downs (eg. Woodside's write-downs on oil/gas ventures – but they are hardly 'one-off' as they have become a habit).

Looking at the main sectors:

Banks/financials – overall $2b *increase* in profits:

- Higher – CBA, ANZ, Westpac, AMP, Suncorp, ASX, Magellan, Netwealth
- Lower – NAB, IAG, QBE, Challenger, Bendigo, Perpetual,
- Losses – QBE, Challenger

Miners – a mixed bag – with commodities prices down generally, except for iron ore and gold. $1b in lower profits overall:

- Higher – Fortescue (+$1.5b), Oz Minerals (copper), Newcrest (gold), Evolution (gold), Independence Group (nickel, copper)
- Lower – BHP, RIO, South32, Iluka(mineral sands), BlueScope (steel), Lynas (lithium)
- Losses – South32

Energy – a sea of red ink - $7b reduction in total profits:

- Higher – Worley (but due to one-off acquisition)
- Lower – Woodside, Origin, Santos, Whitehaven, AMPOL (ex-Caltex), Oil Search, Senex, Beach, Viva, Coronado
- Losses – Woodside, Santos, Ampol, Oil Search, Senex, Coronado

Healthcare – overall $1.3b reduction in profits:

- Higher – CSL, Ansell, ResMed, Mesoblast
- Lower – Cochlear, Medibank, Sonic, Healius, Virtus, Estia, Ramsay, Blackmores
- Losses – Cochlear, Healius, Estia

REITs (listed property trusts) - $4.5b reduction in overall profits:

- Higher – Charter Hall Group, APN Industrial, Redcape (hotels), Arena, Charter Hall Long WALE, BWP (Bunnings), Cromwell,
- Lower – Goodman, Scentre, Stockland, Vicinity, Dexus, Mirvac, LendLease, Charter Hall Retail, HPI, Abacus, SCA, Centuria (all three), ALE, Cedar Woods, National Storage, Jennings
- Losses – GPT, Stockland, Vicinity, LendLease

Most of the cuts to 'profits' in this sector were downward revelations of properties, reversing the artificial upward revaluations they booked as 'profits' during the recent boom years. Their operating revenues and profits were also significantly lower for the retail and office trusts, but higher for the industrial trusts and property developers.

Retail & consumer products/services - $9b reduction in overall profits:

- Higher – JB, Harvey Norman, Reject Shop, Domino's Pizza, APN, Kogan, Shaver Shop
- Lower – Woollies, Coles, Wesfarmers, Mosiac Brands, Super Retail, Crown, Tabcorp, Star casino, CC Amatil, a2 Milk, Treasury wines, Breville, Marley Spoon, Flight Centre, Eagers, Lovisa
- Losses – Flight Centre, Mosaic, Tabcorp, Star, CC Amatil.

Industrials - $7b reduction in overall profits:

- Higher – Amcor (packaging), Aurizon (Qld rail, coal), AdBri, Austal (shipbuilding), Orora (packaging),
- Lower – just about everything else – mainly transport stocks – Transurban, Atlas, Qantas, Sydney Airport, Auckland Airport, Brambles, Boral, also Downer, Seek
- Losses – Transurban, Qantas, Sydney Airport, Boral, Downer, Seek

Telco/comms - $3b reduction in overall profits:

- Higher – Southern Cross Media
- Lower – News Corp, Telstra, Seven, Nine
- Losses – News, Nine, HT&E

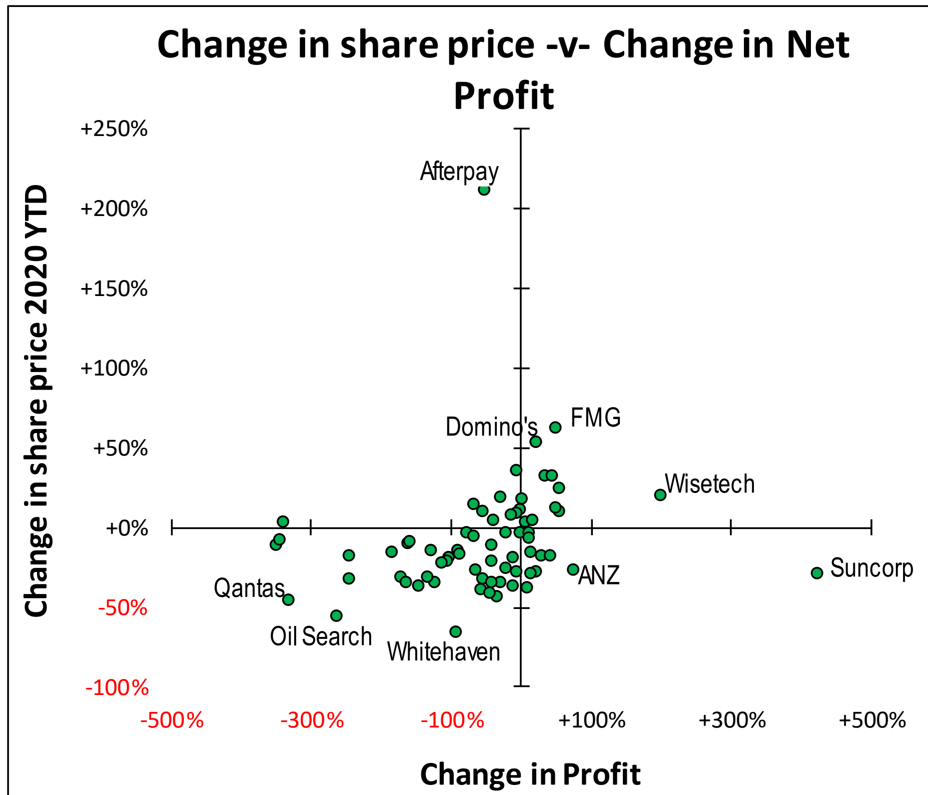
Tech - $800m reduction in overall profits:

- Higher – WiseTech, Appen, Carsales

- Lower – everything else – including Computershare, REA, Domain, Webjet, Corporate Travel, Tyro, Altium, Zip, Flexigroup
- Losses – Afterpay, Zip, Tyro, Corporate Travel, Webjet, Domain

Utilities – profits flat overall

The next chart plots companies by their change in share price in 2020, versus their change in reported net profits to June.



Afterpay reported another big loss but at least it was lower than last year. Most companies are in the lower-left segment – with lower profits and share price falls.

DIVIDENDS

While 'profit' is a rubbery concept that is relatively easy to manipulate or fudge, depending on the skill of the accountants and how lazy and/or conflicted the auditors are, cash dividends are more concrete. (Cash dividends are not without their problems of course – one should not automatically assume that a cash dividend means the company is profitable or financially healthy – as it could be paying dividends by borrowing or by reducing R&D, etc, but at least cash dividends are harder to fudge and can be banked and spent by the shareholders).

Of the largest 160 companies, 140 paid dividends in the prior year. Of these: only 25% increased their dividends in this reporting season, 10% kept dividends at the same level, 35% reduced them, and 30% cancelled them (ie reduced the dividend to zero).

Bank/financials:

- Increased dividends from - ASX, Magellan, Netwealth, AMP (restoring prior dividend cuts from prior losses)
- Reduced dividends - CBA, ANZ, NAB, QBE, Suncorp, Perpetual,
- Cancelled - Westpac, IAG, Challenger, Bendigo Bank

The banks are under instructions from the bank regulator APRA to cut dividends by at least 50% to build up their capital reserves in readiness for a possible flood of bad debts as borrowers are weaned off government welfare. The recovery path for bank dividends is heavily dependent on what APRA allows, which in turn relies on the bad debt cycle from the recession.

Miners:

- Increased – RIO, Fortescue, Min Resources (iron ore, lithium), Evolution (gold),
- Flat – Oz Minerals, BlueScope
- Reduced – BHP, South32, Newcrest

- Cancelled – Iluka (mineral sands)

Energy:

- Increased - Worley (oil&gas engineering)
- Flat - Beach (oil)
- Reduced - Woodside, Origin, Santos, Viva
- Cancelled - Whitehaven coal

Healthcare:

- Increased – CSL, Ansell,
- Flat – Sonic, ResMed
- Reduced – Medibank
- Cancelled – Cochlear, Healius (Primary), Virtus, Estia, Ramsay, Blackmores

The healthcare sector is a mixed bag in terms of the impacts of the virus. Ansell benefited greatly from the global surge in spending on protective equipment, but the operators of private hospitals and clinics suffered from lower spending on elective surgeries. CSL was originally set up by the government in WW1 and it developed a vaccine for the 1918-20 'Spanish flu', but does not appear to be in the running for the current virus.

REITs:

- Increased – Dexus, Charter Hall Group, Arena, Centuria (all three companies: Capital, Industrial, Office), BWP (Bunnings), Cromwell
- Flat – Goodman, ALE (pubs),
- Reduced – GPT, Stockland, Mirvac, LendLease, Charter Hall Retail, HPI (hotels), Redcape, Abacus, SCA (ex-Westfield)
- Cancelled – Scentre (ex-Woollies), Vicinity, Jennings

Retail & consumer products/services:

- Increased – Coles, JB, Kogan, Breville, Shaver Shop
- Flat - Wesfarmers
- Reduced – Woollies, Harvey Norman, Super Retail, CC Amatil, Treasury Wines, Domino's Pizza
- Cancelled – Lovisa, Eagers (cars), Fight Centre, Crown, Tabcorp, Star, Mosaic Brands

Industrials:

- Increased – Aurizon, AdBri, Cleanaway, Austal
- Flat - Seven
- Reduced – Transurban, Atlas Arteria, brambles, Amcor, Monadelphous, Orora
- Cancelled – Qantas, Sydney Airport, Auckland Airport, Boral, Downer EDI, Seek, oO!Media (billboards)

Telco / media:

- Flat – Telstra, News
- Reduced – Nine,
- Cancelled – Southern Cross Media, HT&E

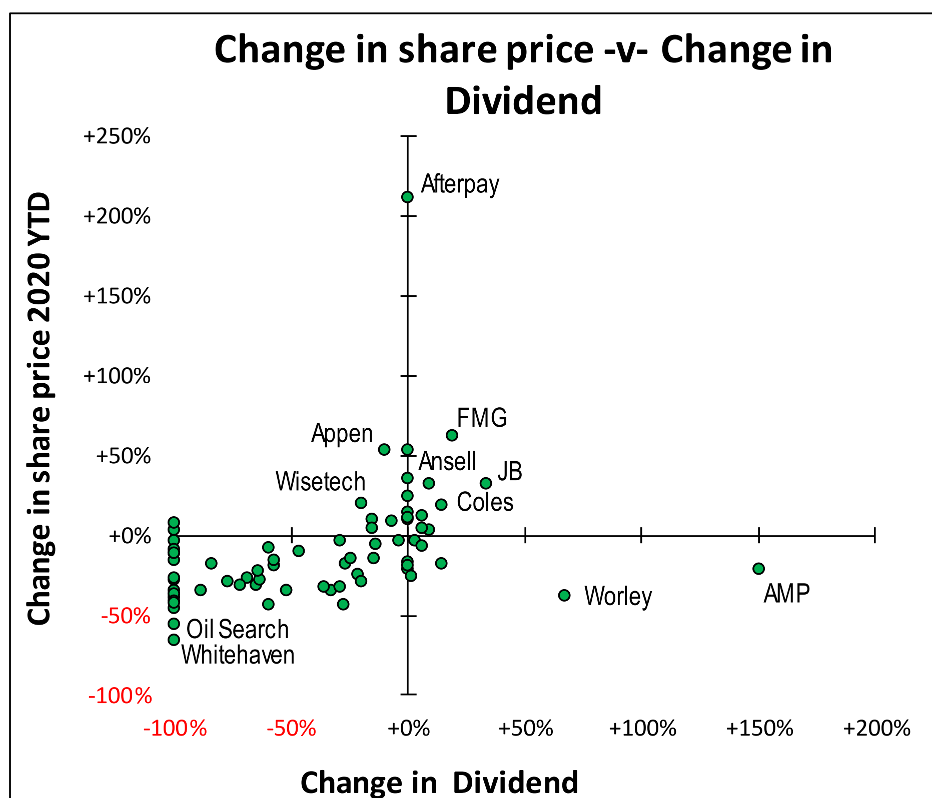
Tech:

- Increased – Altium
- Flat – Computershare, Carsales
- Reduced – REA, WiseTech, Appen
- Cancelled – Domian.com, Webjet, Corporate Travel, Flexigroup

Utilities:

- Increased - APA
- Reduced – AGL, New Energy Solar
- Cancelled – Infigen

The final chart plots the same companies by their change in share price in 2020 versus their change in dividends relative to the same period last year:



Afterpay declared no dividends again and so it appears on the zero dividend growth line. Fortescue (FMG), JB Hi-Fi and Coles were the standouts here, with higher dividends and rising share prices, although FMG's windfall revenues, profits and dividends are not sustainable, and rely on Brazil's difficulties in restarting production and exports.

Most companies ended up in the lower-left segment, with lower dividends and lower share prices. Half of those in the lower-left segment are along the left edge of the segment, indicating cancelled dividends (-100%), plus lower share prices.

Summary

The sea of red ink in profits and dividends in the recent reporting season was largely anticipated in the early days of the virus crisis, and these fears triggered the sharp sell-off in share prices in February-March this year. At that time there were also dire predictions from seemingly reputable authorities and institutions, warning of millions of coronavirus deaths and a flood of corporate bankruptcies.

Neither of these fears were realised. The death rate has been much lower than expected – arguably because of the lock-down measures taken - and the unprecedented government stimulus and support measures were far larger and more comprehensive than expected. As a result, the negative impacts on profits and dividends when they were eventually reported were no worse than initially anticipated, and there are a number of surprisingly positive outcomes in the reports.

Thus far, the combined impact of government efforts to contain the virus and prop up incomes with deficit spending programs, plus support from their central banks to keep interest rates low and keep bond markets liquid so governments can finance their deficits – have been enough to prevent the sea of red ink from worsening, and this has supported share prices.

The medical crisis is far from over, with second and third waves appearing, and no vaccine in sight. The assumption that corporate profits and dividends have bottomed rests on the assumption that further virus outbreaks will be countered with more targeted restrictions rather than prolonged nation-wide 'hard lockdowns'. The current working hypothesis for investors is that further lockdowns will either be short and targeted, or if they are more restrictive or longer-lasting, then governments will continue to top up incomes and spending that directly and/or indirectly flow through to companies and shareholders.

Australia's government debt + interest burden – can we afford it?

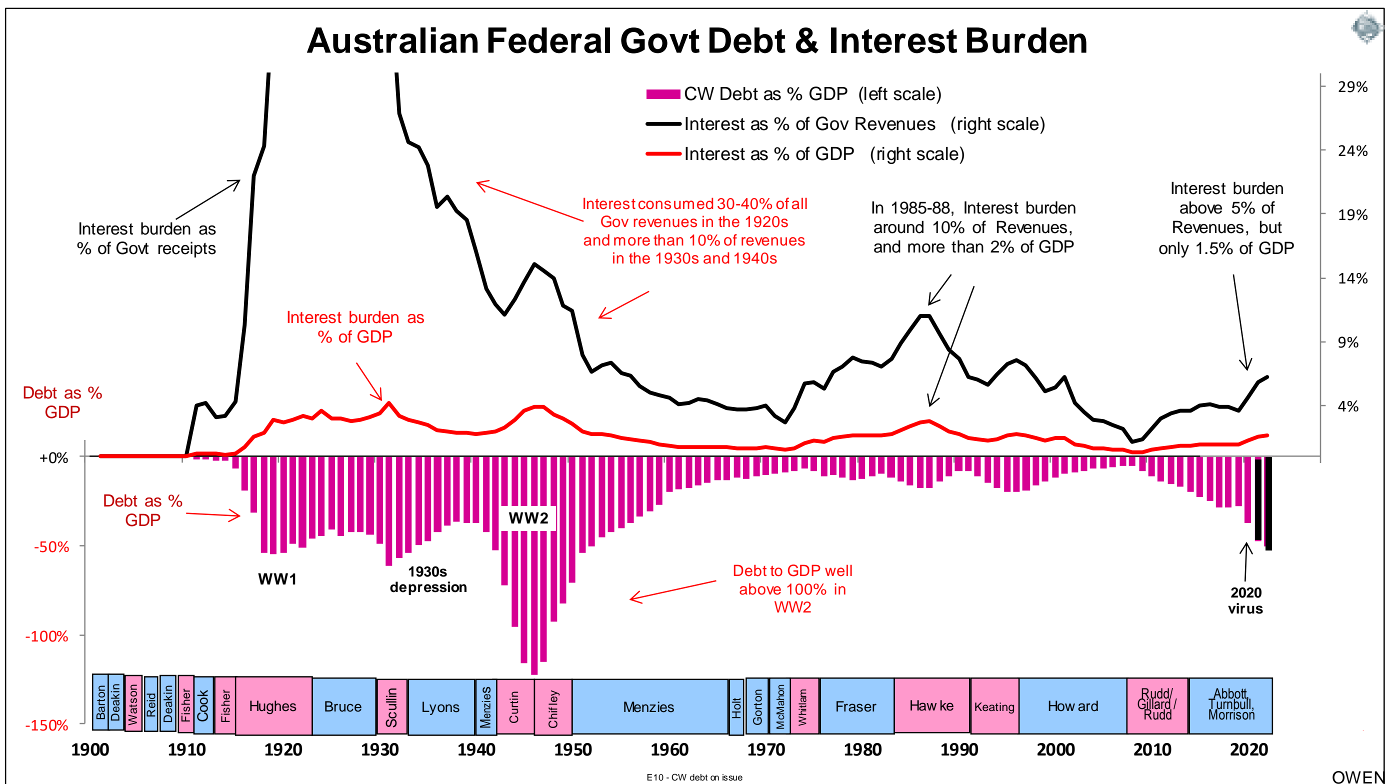
In Australia, the Commonwealth government was carrying very low debt levels of $50b before the GFC. Then, to counter the GFC, it borrowed an average of $50b *per year* net for the next 10 years, taking the level of debt to $560b before the virus hit. Now it is borrowing around $35b *per month* to fund all of its welfare programs. Can we afford all of this debt?

The Commonwealth government ran surpluses for six straight years from 2003 to 2008 in the China/mining boom, then it run up deficits in the GFC to support economic growth and jobs. That is precisely what governments should do - build up surpluses in the good years so they can deficit spend in economic crises to provide short term support for growth and jobs.

The problem was that both Labor and Liberal/National governments since the GFC became addicted to big spending, and kept running up deficits well beyond the GFC crisis. The Commonwealth ran deficits for the next nine years until (and including) 2018, for what was really just a one-year GFC crisis, especially as the Chinese stimulus re-boot in the GFC boosted exports, revenues and jobs from 2010 on. Windfall iron ore revenues produced a tiny surplus in the June 2019 year, but Commonwealth debt had grown from $101b (8% of GDP) in the GFC in 2009, to $540b (28% of GDP) in 2019.

The size of government has been increasing over time as a share of total national spending. In 2007, at the top of the last boom prior to the GFC, Commonwealth spending was $224b (21% of GDP), but by 2019 prior to the virus, it had grown to $448b (25% GDP). During that time the debt pile grew by 830%, but the population grew by just 20%, and CPI inflation had only risen by 30% in total. Then the virus (or rather the virus lockdowns) hit, and the government is now borrowing $30-$50b per month to fund its spending programs. This seems high, but is it?

To provide some context on the national debt, the chart shows Commonwealth government debt, and the debt servicing costs since Federation. The pink bars in the lower section show debt as a percentage of national output (GDP) each year.



Toward the right end of the pink bars, we see the build-up of debt from 2009 on. The two black bars represent likely 2021 and 2022 debt levels assuming the current plan to increase debts by $240b in the current June 2021 year, plus an additional say $100b in the June 2022 year. The 2022 number is pure speculation, but it assumes that there will be further occasional lockdowns and further extensions to the welfare programs. Welfare is extremely difficult to scale back or withdraw (eg the JobSeeker will probably remain at the higher level) and it doesn't even include the government promises of tax cuts (!).

The current level of debt at 37% of GDP is higher than it has ever been since 1956, but still lower than historical average debt levels. The likely 2021 and 2022 levels of debt are also still low relative to the previous big debt build-ups. The main debt build-ups in the past were due to the massive deficit spending in the two World Wars and also in the 1930s depression, although the 1930s were more due to a collapse in incomes rather than increases in spending, as government borrowing was not possible under the bank/London-imposed austerity plan.

In the first half of the 20th century, Australia was seen a high risk 'emerging market' borrower, and a pariah in global debt markets after it suffered a default and full-scale Greece-style debt restructure in 1931. Australia only regained respectability as a borrower in global debt markets after the post-war economic boom reduced debt levels in the 1950s.

We have written previously about how Australia's current level of government debt is very low relative to most of our global peers, and even the 2021 and 2022 levels would be low in global terms. (It is a very different story for household debt levels, which are among the highest in the world).

Affordability of debt

The fact that the level of Commonwealth debt is not high in historical terms nor relative to most other countries in the world, does not automatically make it 'right' or prudent. More important than the level of the debt is its affordability.

The current $684 billion of debt costs tax-payers $22 billion per year in interest, or $61 million every day, or $2.40 per person per day (less than one coffee per day per person!). The total interest burden sounds like a lot but there is more to the story.

The affordability of the debt is shown in the upper section of the chart. Interest on government debt as a percentage of national income (GDP) (red line), and also the percentage of government revenues (mainly tax), (black line). The current interest burden is quite modest, at 4.5% of government revenues and just 1.2% of national income. This is lower than almost any other time since the early 1950s, and also lower than almost every other country in the world today. Even the likely 2021 and 2022 debt levels would see the interest burden at around 5% of government revenues and 1.5% of total national income.

The reason for the relatively low interest burden is that the interest rates on government bonds are at historical all-time lows thanks to declining global bond yields since the GFC, and the RBA pegs and bond-buying since the virus crisis.

However, the current era of ultra-low bond yields will not last forever. Bond yields will probably rise in the medium term as economic activity recovers here and around the world. The good news is that rising bond yields don't translate into higher interest payments until each bond matures in the future and is re-financed by another bond at a higher prevailing rate at that time, which in some cases is thirty years into the future. Even if bond yields rise rapidly in the next few years, the average interest cost on the total pile of debt will remain low for at least another decade because of the low rates already locked in.

If Australia was a company, its national debt would be labelled a 'lazy balance sheet' and the CEO and Chairman would be fired by shareholders for not borrowing enough to invest in productive assets for future growth.

Based on affordability, these levels of debt are manageable – but there is one major caveat. Investing for the long term future requires coherent vision, long-term commitment and a willingness to make tough decisions. These require longer election cycles than the current theoretical three-year terms (which never last the full three years), and recently have been punctuated by 'palace coups' within the ruling parties between elections. The conditions for good long term decision-making have been sadly lacking in the recent succession of short-term revolving-door governments in Canberra.

With that caveat in mind, Australia's position is one of the best in the world. It has always been a country in which the opportunities for growth and investment have far exceeded the local savings pool available to fund its development, and so it has always had to import people and capital.

A country is not a household

When talking about debt, many people liken a country to a household, where it is prudent to have no debt, or at least to pay off debts as quickly as possible (although try telling that to a Millennial!). In a household, the breadwinner(s) stop generating income at some point and thereafter have to draw down their accumulated savings to fund decades of retirement spending with no labour income. However, a country is more like a company than a household. Companies and countries can last forever (in theory anyway) and they can (and probably should) carry a level of debt, as long as the cost of debt is lower than the additional income generated by the productive assets funded by the debt. Ideally, the debt should be in the country's own currency (as is 100% of Australia's debt), and should mainly be fixed-rate, not floating, so the level of interest payments is not volatile (this is also true for Australia).

Most countries lie somewhere between these two views. Australia has an aging population and rising welfare and health costs, but it is still the best placed among its 'developed' country peers due to its relatively favourable demographics and healthy immigration programs targeting work-ready individuals and families. It is far better placed than Japan and northern Europe that have declining populations, declining workforces and declining tax-payer bases. Those countries are indeed more like households, where the breadwinners in aggregate are reducing their income-generating ability, and are literally dying off.

What lies ahead?

August was another fascinating month for investment markets. An ocean of red ink in company profit reports and economic growth numbers came and went with little impact. While there were differences in the details, the aggregates were no worse than the early expectations that triggered the sharp sell-offs in shares, bonds, commodities and currencies six months ago. Each of these markets has now more or less recovered, mainly because of the unprecedented support from governments and their central banks. The current working hypothesis is that the coronavirus crisis is far from over, with governments walking a tightrope between increasing and easing restrictions, and back again, with a few missteps along the way.

For share markets – the base case is that is that corporate revenues, profits and dividends have probably seen the worst of the crisis, and that further virus outbreaks will be countered by lockdowns that will either be short and targeted, or if they are more restrictive or longer-lasting, then governments will continue to top up incomes and spending that directly and/or indirectly flow through to companies and their shareholders.

For bond markets – the initial fears in March that governments would have trouble selling the mountains of bond issues needed to finance their huge deficit spending programs, appear to have been assuaged by soothing tones from the governments' new favourite departments – their central banks. Since the March crisis they have been bending over backwards to assure the world that they will do whatever it takes to keep interest rates low and bond markets open and liquid, so that their government masters can keep issuing bonds at ultra-low rates to fund the deficits.

Bonds are currently priced at levels that assume zero economic growth and zero inflation for decades – in every country!. This is probably fair for Europe and Japan (which make up half of the world economic pie), but it does not make any sense at all for the US, Australia and other countries with favourable demographics and growing populations. Medium-term inflation is the main risk here, and that will impact not only bond markets, but share markets as well.

China is a hybrid case – with rapidly deteriorating demographics, very low population growth, and negative migration. On the plus side, it has enormous capacity for internally generated growth through continued urbanisation and militarisation, backed by huge foreign reserves and trade surpluses. Australia relies heavily on China for export revenues, and China relies just as heavily on imports from Australia. China has been working hard to reduce its reliance on Australian imports, but Australian businesses have been slow to realise that they must do the same to reduce their reliance on China.

The US is in the young/growing camp like Australia, but it has a host of self-inflicted domestic problems in addition to its self-inflicted external problems. Much will depend on the outcome of the November elections, not just for the President but also for the Senate (33 seats contested) and the House (435 seats). The lessons from the 2016 elections were that not even exit polls can predict election outcomes, also that market reactions can also be very volatile and can reverse within minutes. We are not in the business of taking sides or setting portfolios for one outcome or another, but rather to steer investors through whatever turmoil erupts from time to time, and to keep portfolios and investors on track to achieve their long term goals.

We remain vigilant and ready to make further adjustments as conditions evolve, and we will keep you informed of developments and changes.

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Monthly returns since inception:

Soteria Conservative 'Dynamic Active' Neutral Growth/Defensive Mix: **30/70** Long term goal = CPI+ **+3.0%**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2017	-0.06%	0.99%	0.96%	0.89%	0.46%	-0.28%	0.06%	0.41%	0.14%	1.53%	0.69%	0.41%
2018	0.05%	-0.38%	-0.40%	0.96%	0.55%	0.87%	0.29%	0.88%	-0.51%	-0.96%	-0.42%	0.31%
2019	1.33%	1.60%	1.24%	0.70%	0.39%	1.98%	1.36%	0.63%	0.18%	-0.13%	1.33%	-0.80%
2020	2.34%	-2.14%	-7.87%	2.37%	1.47%	0.33%	0.70%	1.26%				

Returns are Net of internal & external fund fees & costs, net of Soteria Model fees)

Soteria Moderate 'Dynamic Active' Neutral Growth/Defensive Mix: **50/50** Long term goal = CPI+ **+3.5%**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2017	-0.28%	1.32%	1.38%	1.11%	0.51%	-0.34%	-0.14%	0.53%	0.32%	2.20%	1.06%	0.61%
2018	0.25%	-0.54%	-0.88%	1.52%	0.77%	1.20%	0.46%	1.11%	-0.68%	-1.81%	-0.63%	-0.12%
2019	1.83%	2.23%	1.31%	1.16%	-0.14%	2.58%	1.78%	0.19%	0.50%	-0.02%	1.89%	-0.84%
2020	2.74%	-3.83%	-10.88%	3.54%	1.90%	0.24%	0.71%	2.18%				

Returns are Net of internal & external fund fees & costs, net of Soteria Model fees)

Soteria Balanced 'Dynamic Active' Neutral Growth/Defensive Mix: **65/35** Long term goal = CPI+ **+4.0%**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2017	-0.42%	1.61%	1.70%	1.27%	0.55%	-0.44%	-0.18%	0.57%	0.50%	2.69%	1.40%	0.71%
2018	0.31%	-0.63%	-1.28%	1.80%	0.89%	1.29%	0.60%	1.27%	-0.64%	-2.32%	-0.66%	-0.56%
2019	2.25%	2.65%	1.40%	1.49%	-0.54%	3.09%	2.13%	-0.26%	0.69%	0.14%	2.24%	-0.79%
2020	3.02%	-5.08%	-13.07%	4.31%	2.39%	0.28%	0.79%	2.87%				

Returns are Net of internal & external fund fees & costs, net of Soteria Model fees)

Soteria Growth 'Dynamic Active' Neutral Growth/Defensive Mix: **80/20** Long term goal = CPI+ **+4.5%**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2017	-0.47%	1.88%	1.98%	1.38%	0.61%	-0.42%	-0.21%	0.60%	0.69%	3.17%	1.60%	0.92%
2018	0.57%	-0.83%	-1.63%	2.21%	0.97%	1.51%	0.72%	1.44%	-0.70%	-2.94%	-0.78%	-0.86%
2019	2.60%	3.15%	1.40%	1.89%	-1.03%	3.51%	2.46%	-0.70%	0.99%	0.24%	2.64%	-0.76%
2020	3.29%	-6.37%	-15.62%	4.41%	2.67%	0.13%	0.60%	3.58%				

Returns are Net of internal & external fund fees & costs, net of Soteria Model fees)

Soteria High Growth 'Dynamic Active' Neutral Growth/Defensive Mix: **95/5** Long term goal = CPI+ **+5.0%**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2017	-0.70%	2.14%	2.31%	1.68%	0.71%	-0.61%	-0.37%	0.71%	0.85%	3.69%	1.91%	0.97%
2018	0.65%	-0.98%	-2.05%	2.64%	1.23%	1.76%	0.96%	1.68%	-0.80%	-3.76%	-0.92%	-1.38%
2019	3.24%	3.64%	1.51%	2.30%	-1.41%	3.97%	2.65%	-0.97%	1.08%	0.42%	3.04%	-0.76%
2020	3.46%	-7.23%	-17.15%	5.29%	3.09%	0.13%	0.74%	4.22%				

Returns are Net of internal & external fund fees & costs, net of Soteria Model fees)

Soteria Conservative 'Dynamic Index' Neutral Growth/Defensive Mix: **30/70** Long term goal = CPI+ **+3.0%**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2018										-1.29%	-0.43%	0.19%
2019	1.45%	1.77%	1.44%	0.49%	0.55%	2.04%	1.53%	0.45%	0.18%	-0.19%	1.42%	-0.93%
2020	2.60%	-2.44%	-8.10%	3.11%	1.14%	0.54%	0.77%	1.24%				

Returns are Net of internal & external fund fees & costs, net of Soteria Model fees)

Soteria Moderate 'Dynamic Index' Neutral Growth/Defensive Mix: **50/50** Long term goal = CPI+ **+3.5%**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2018										-2.48%	-0.73%	-0.37%
2019	2.13%	2.66%	1.41%	1.07%	0.16%	2.63%	2.05%	-0.15%	0.52%	-0.03%	1.99%	-1.00%
2020	3.16%	-4.34%	-11.01%	4.46%	1.36%	0.48%	0.78%	2.25%				

Returns are Net of internal & external fund fees & costs, net of Soteria Model fees)

Soteria Balanced 'Dynamic Index' Neutral Growth/Defensive Mix: **65/35** Long term goal = CPI+ **+4.0%**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2018										-3.39%	-0.92%	-0.90%
2019	2.66%	3.27%	1.38%	1.50%	-0.18%	3.06%	2.41%	-0.70%	0.84%	0.13%	2.41%	-1.03%
2020	3.49%	-5.73%	-13.93%	5.10%	1.77%	0.49%	0.73%	3.05%				

Returns are Net of internal & external fund fees & costs, net of Soteria Model fees)

Soteria Growth 'Dynamic Index' Neutral Growth/Defensive Mix: **80/20** Long term goal = CPI+ **+4.5%**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2018										-4.12%	-1.02%	-1.35%
2019	3.12%	3.85%	1.37%	1.88%	-0.55%	3.50%	2.77%	-1.21%	1.14%	0.28%	2.85%	-1.04%
2020	3.85%	-7.11%	-16.74%	5.71%	1.86%	0.39%	0.54%	3.77%				

Returns are Net of internal & external fund fees & costs, net of Soteria Model fees)

Soteria High Growth 'Dynamic Index' Neutral Growth/Defensive Mix: **95/5** Long term goal = CPI+ **+5.0%**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2018										-5.17%	-1.22%	-1.91%
2019	3.79%	4.43%	1.38%	2.28%	-0.97%	3.86%	3.05%	-1.62%	1.45%	0.38%	3.24%	-1.00%
2020	4.07%	-8.22%	-17.97%	6.95%	2.31%	0.42%	0.84%	4.54%				

Returns are Net of internal & external fund fees & costs, net of Soteria Model fees)